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# Securities hot topics in 2019: A whirlwind expert review

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Over the past week, *Securities Regulation Daily* has published in-depth reviews of 2019 developments, including activities in the areas of the SEC, CFTC, corporate governance, and legislation.

For a short summary focusing on 2019 hot topics, here we have picked top blog posts from our weekly "Blog Tracker" feature to let expert practitioners explain some of the biggest trends and developments in 2019, including:

- Continued dramatic growth of securities litigation and calls for reform;
- The SEC's adoption of Regulation Best Interest and related Form CRS and interpretations regarding the duties broker-dealers and advisers owe to customers;
- Corporate governance hot spots, including controversial proposed SEC rules on proxy advice and shareholder proposals, as well as continued debate on the role of ESG (environmental-social-governance) in corporate social responsibility; and
- An emerging legal framework for digital assets and cryptocurrencies.

Ready? Let's go!

## Securities litigation: The flood continues

Securities class actions continue to grow at a record pace, even as the number of publicly listed companies has shrunk. According to John C. Coffee, Jr. at the CLS Blue Sky Blog, a public company now faces a 1 in 12 chance of attracting a securities class action in a given year. Settlement amounts have risen also, as noted by Kevin LaCroix at D&O Diary, citing Cornerstone Research. Why?

Coffee particularly notes a jump in federal merger objection cases following the Delaware *Trulia* decision, which curbed attorney fees in disclosure-only settlements, and an increase in event-driven lawsuits prompted by disasters like the Boeing plane crashes. Alexandra Boudreau and Daniel Halston at the Harvard Law School Forum on Corporate Governance also see a post-*Trulia* effect. LaCroix points to the U.S. Supreme Court's 2018 *Cyan* decision—though we may also be seeing the start of a trend of dismissals of Section 11 claims by state courts—as well as an increase in the resolution of merger objection cases through opaque "mootness fees." Doug Greene at D&O Discourse faults a trend of premature settlement. Hidden, indirect "pay to play" arrangements, explored by Benjamin Edwards and Anthony Rickey, could also play a role.

Many agree that the proliferation is increasing costs for companies and wasting court resources. In fact, LaCroix states that *half* of the total cost of securities litigation over the past five years has gone to attorneys.

As a result, insurers, business groups, and others have increasingly called for reforms. This could include:

- Courts could cull unworthy merger objection cases by imposing Rule 11(b) sanctions under Exchange Act Section 21D(c)(2);
- Courts could limit attorney fees under Exchange Act Section 21D(a)(6), potentially concluding that disclosure-only settlements do not justify a fee award;
- Courts could view materiality and scienter more skeptically in event-driven lawsuits where the risk seemed remote at the time the corporate issuer made its disclosures;
- Courts could disfavor plaintiffs' dismissals of M&A class claims without prejudice, since that leaves the threat of litigation by other plaintiffs hanging over the company;
- Courts could prohibit parties from discussing settlement of any class claims before class certification, thus forcing plaintiffs' counsel to investigate class claims thoroughly and avoid settling for less than the class deserves;
- Courts could move expert damages analysis and discovery ahead of fact discovery, allowing parties to more quickly assess the size of the case;
- Congress could enact legislation to overturn *Cyan* and/or eliminate the private right of action in Section 14;
- Defense lawyers could form a pool from which insurers and brokers could establish small panels—formal or informal—to defend securities class actions against small and medium-sized companies;
- Corporations could include mandatory arbitration provisions in their charters—though this is potentially problematic following the December 2018 Delaware Chancery Court decision in *Sciabacucchi v. Salzberg*.

As Coffee points out, permissive court decisions could mean that class action volume will continue to mushroom. This would only strengthen calls for reform, so we can expect to see this as a continued topic of interest for 2020.

## Fiduciary duties for investment advice: New SEC rules and state proposals

In June, the SEC adopted Regulation Best Interest, Form CRS, and related interpretations. As a Proskauer alert explains, these impose a new standard for broker-dealers to act in a retail customer's best interest when making recommendations and a requirement for brokers and advisers to disclose relationship summaries to retail investors.

Reg BI has since been challenged in court by attorneys general from seven states and the District of Columbia. As described in a Ballard Spahr alert, the suit alleges that the SEC's requirements fall short and do not comply with Section 913 of the Dodd-Frank Act. A similar challenge was also filed by financial planning firms.

But so far, the lawsuits do not seem to be derailing the rule. In October, as White & Case reported, SEC Chairman Jay Clayton confirmed that the SEC does not plan any delays and said firms need to be ready for enforcement of Regulation Best Interest as of the compliance date of June 30, 2020.

And, as if the SEC requirements were not enough to keep up with, several states have also proposed their own legislation and regulation on fiduciary duties, as detailed in this Eversheds Sutherland chart.

With the aggressive compliance timeline, registrants are shaping up their systems and law firms are offering guidance. Morgan Lewis has a resource center for all things Reg BI, including a description of the requirements, implementation tips, and form templates, as well as a slightly ominous count-down clock. WilmerHale also offers a timeline for implementation.

As firms continue to build out their systems before the Reg BI compliance date in June and state proposals may complicate the picture, fiduciary duty issues will no doubt continue to be an intense focus this year.

## Corporate governance: Proxy advice, shareholder proposals, and ESG

The SEC took several contested actions relating to proxy advisory firms and their use by investment advisers. These actions played out against an ongoing debate of corporate social responsibility and what some see as a tension between environmental-social-governance (ESG) issues and shareholder primacy.

### Proxy advisory firms and shareholder proposals

In a "first strike" in August, the SEC issued two interpretive releases. As explained in a Shearman alert, the first release addressed how the federal securities laws apply to advice provided by proxy advisory firms, and said among other things that providing proxy voting advice constitutes a "solicitation." The second release addressed how investment advisers can fulfill their obligations to their clients in voting the proxies of securities held in their accounts, including factors that advisers should consider when retaining proxy advisory firms.

ISS then challenged the SEC guidance in court, as reported by Cydney Posner at Cooley PubCo. This set the stage for November, when the SEC proposed changes to rules governing proxy advisory firms. Posner laid out the details, which include proposed amendments to the definition of "solicitation" in Rule 14a-1(l) and the availability of exemptions in the proxy solicitation rules in Rule 14a-2(b). The rule would also provide a standard opportunity for all registrants to review the advice within a certain timeframe and provide illustrations of potentially problematic misstatements by proxy advisory firms.

Supporters of the rule say it addresses concerns about errors, incomplete or outdated information, conflicts of interest, and outsized influence on corporate matters. Opponents contend that proxy advisory firms are an effective "market-based solution" that helps large numbers of institutional investors with time and resource constraints make better voting decisions, and that the proposed regulations are not needed.

Posner summed up the controversy:

> "Chair Jay Clayton observ[ed]that a 'system in which five individuals accounted for 78% of all the proposals submitted by individual shareholders' needs some work, and Commissioner Robert Jackson characterize[ed] the proposal as swatting 'a gadfly with a sledgehammer.'"

Comments on the proposal are due on February 3, 2020. Given the strong divisions, this proposal is sure to be closely watched.

At the same open meeting, the SEC also proposed to "modernize" the shareholder proposal rules by increasing the eligibility and resubmission thresholds. As Posner explained, proponents including Chair Clayton framed the proposed amendments as better reflecting the modern reality of shareholder proposals in which just five individuals submit the vast majority of individual shareholder proposals. But Commissioners Jackson and Allison Lee dissented, viewing the proposal as a series of limitations on shareholders' ability to hold corporate insiders accountable.

Again, as a fraught area with substantial stakes for public companies, many eyes will be on this proposal.

### Corporate social responsibility and ESG

The tussle over how much corporations should concern themselves with societal issues versus maintaining a laser focus on shareholder profit continue to rage. In one corner, we have proponents of shareholder primacy, as laid out by Peter Atkins and others in a Skadden article.

In support, the article quotes former Delaware Supreme Court Chief Justice Leo E. Strine, Jr. from a 2015 publication:

> "[A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."

But Strine's views appear to have significantly evolved since 2015. In a *New York Times* opinion piece in August, he argued that the aims of worker-investors, represented by institutional investors in the form of retirement funds, are not being adequately taken into account.

> "The worker-investors are not single-issue voters, solely focused on shareholder returns. The vast majority of their income and ability to build wealth depends on continued access to good jobs. They will suffer unless corporations make money in a manner that works for employees, consumers and the environment," wrote Strine.

Strine's op ed followed close on the heels of a Business Roundtable statement, which, as reported by Jena McGregor in the *Washington Post*, "ditch[ed] more than two decades of dogma that shareholders should always come before everything else."

The statement expanded a company's commitment to include not just shareholders but also other "essential stakeholders" including customers, employees, suppliers, and communities.

ESG issues, including questions about environmental responsibility, diversity and other human capital issues, and discrete issues like weapon sales, are contentious and could particularly gain traction in an election year. For more detail, see "Corporate law in 2019: ESG is in, WeWork is out, and the state to watch is… Wyoming?", *Securities Regulation Daily,* January 8, 2020.

## Digital assets and virtual currencies: Mapping the corners

The SEC and CFTC continued to fill in the legal framework for digital assets and virtual currencies in 2019, providing more certainty on where these new instruments fit in the existing regulatory regime and what is and isn't allowed.

In April, SEC staff issued a "Framework for 'Investment Contract' Analysis of Digital Assets." As detailed in a McDermott alert, the framework provides a list of 65 factors to consider in determining whether an initial coin offering (ICO) is a security, guided by classic *Howey* considerations. According to McDermott, although many of the factors that favor finding that an ICO is a security are present in the "vast majority" of ICOs, the SEC did leave open the possibility of non-security ICOs.

Accompanying the framework, staff provided no-action relief to a non-security ICO, TurnKey Jets, finding that the token's characteristics took it outside the realm of securities and so the tokens did not need to be registered. As reported by Andrew Silver at FTC Beat, staff subsequently provided similar no-action relief to another ICO, Pocketful of Quarters.

Some financial instruments, for example bitcoin and ether, tend more in the direction of virtual currencies than security ICOs. But how to tell? A Latham & Watkins alert by Stephen Wink and others notes that in an interview, CFTC Chairman Heath Tarbert stated that the initial threshold determination is whether the SEC considers a digital asset a security. If so, the CFTC deems it a security, and it will not be treated as a commodity.

With that guidance in place, in July the SEC approved its first supervised token offerings under Regulation A+, permitting Blockstack Token LLC and YouNow Inc. to conduct token fundraisings. As Andrey Yanai at Barnea Law observed, this indicates that while the SEC takes a harsh stance against companies it believes are violating the rules, it is willing to give its official stamp of approval to companies prepared to toe the line. Although Blockstack's cost was $2 million for conducting a $28 million offering, it is expected subsequent security token offering fundraisings will be much more cost-effective. A Wilson Sonsini white paper by Robert Rosenblum and others in the firm's Blockchain and Cryptocurrency group gives useful, detailed information on how to conduct a token offering under Regulation A.

Speaking of violating the rules, the SEC cracked down on a number of unregistered ICOs. Significantly, in June, the SEC filed its first contested litigation against a digital asset issuer, Kik Interactive, that alleged solely non-fraud, registration violations.

While some may see this as the SEC playing hard ball, Steven Quinlivan at Dodd-Frank.com observed that the charges were only brought against Kik Interactive itself, not any individual officers, directors or others that participated in the alleged unregistered offering, marking a difference from other unregistered ICO enforcement actions. Nevertheless, Kik has fought back vigorously and publicly, even taking the unusual step of making the SEC's Wells Notice public, as reported by Daniel Nathan and others at Orrick.

In another hotly contested action, Telegram disputes that its "Gram" tokens are securities, as the SEC alleged in an October emergency action ahead of a planned offering. As Andrew Silver at FTC Beat explained, Telegram raised approximately $1.7 billion in presales via a Regulation D offering limited to "accredited investors." The SEC contends that Telegram did not clearly disclose to investors that it planned to use funds from the presale to develop its blockchain technology—which was not a functioning network at the time of the sale—and pay related expenses. But so far, Telegram has signaled that it will fight the SEC's claims.

One tech giant did back down on a planned crypto offering, however. In September, in the face of fierce legislative scrutiny, Facebook informed Rep. Emanuel Cleaver, II (D-Mo) in a letter that it would cooperate and provide any information necessary for federal regulators to review its Libra plans, and committed not to launch Libra until all regulatory concerns were addressed. And after Facebook CEO Mark Zuckerberg faced a stern grilling by the House Financial Services Committee in October, as detailed in the *New York Times*, public discussion of Libra has somewhat faded to the back burner.

We expect that the digital assets picture will continue to come into focus in 2020 as the SEC continues to pursue enforcement actions and possible further no-action relief and approved token offerings.

## Conclusion

Designed as a quick review of current hot topics, this look back at 2019 developments can only scratch the surface. For a deeper dive, see these *Securities Regulation Daily* year-in-review pieces:

- The SEC in 2019: The path forward draws strong opposition
- The CFTC in 2019: A New Chairman, an Ambitious Agenda, and a Fierce Battle with Kraft Foods mark the year
- Corporate law in 2019: ESG is in, WeWork is out, and the state to watch is… Wyoming?
- Congress in 2019: Democrat-led House presses new agenda while Senate recedes in first session of 116th Congress

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